No. 8994.

In the United States Circuit Court of Appeals

For the Ninth Circuit.

F. E. KLIPSTEIN,

Appellant,

vs.

HERBERT P. SEARS, Trustee in Bankruptcy of the Estate of Globe Drug Company, Inc.,

Appellee.

APPELLANT'S OPENING BRIEF.

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BASIS OF JURISDICTION.

The basis on which it is contended that the District Court had jurisdiction, as disclosed by complainant's amended bill [Tr. p. 5], is section 70(e) of the National Bankruptcy Act (Act of July 1, 1898, c. 541, §70(e), 30 Stat. 565, as amended by Act of Feb. 5, 1903, c. 487, §16, 32 Stat. 800, U. S. C. A. (1928), Title 11, §110(e). This appeal is from a final decree entered in a suit in equity before the District Court for the Southern District of California. [Tr. p. 32.]

STATEMENT OF THE CASE.

This is a separate appeal by the defendant T. E. Klipstein from a final decree in a suit in equity brought by the complainant Sears, as trustee of the estate of Globe Drug Company, Inc., bankrupt, to compel the defendant Lew O. Stelzner and the defendant and appellant T. E. Klipstein to account for moneys alleged to have been illegally diverted from the corporation.

Complainant's amended bill [Tr. p. 5] alleged that at all times since 1928 Globe Drug Company, Inc., was a duly organized California corporation of which defendants Stelzner and Klipstein were stockholders, directors and officers; that in 1928 Stelzner and Klipstein borrowed $17,000.00 from Bank of America on their joint promissory note and used the proceeds to purchase certain outstanding shares of the corporation; that from that time until October 19, 1935, at least $12,200.00 was paid from corporate funds upon the note, for which payments the corporation received no consideration; that during this period the corporation owed various sums to various creditors and was insolvent and that such payments were made for the purpose of hindering, delaying and defrauding creditors; that on October 19, 1935, the balance unpaid on the note was $4,800.00 and that on that day Stelzner and Klipstein, as directors and officers, executed a promissory note of the corporation to the bank in said amount; that Klipstein thereupon purchased the corporate note from the bank and brought an action against the corporation in which a default judgment was allowed to be entered and all of the assets of the corporation, of the value of $5,000.00, sold at public auction by the sheriff; that said suit and sale were effected for the purpose of hindering, delaying and defrauding creditors; that the corpora-

tion was adjudicated a bankrupt in April, 1936; that Sears was appointed trustee of its estate on April 18, 1936; that creditors have proved their claims in the bankruptcy proceedings and that the assets of the estate are insufficient to pay such claims in full.

Defendant Stelzner, answering separately [Tr. p. 16], admitted that he had personally borrowed the money from the bank and had used the same to purchase stock of the corporation; alleged that Klipstein had endorsed Stelzner's note to the bank for the accommodation of Stelzner, who caused the stock purchased to be issued to Klipstein as security; admitted that payments were made as alleged on the note but denied that the corporation was insolvent at such times; admitted that suit had been brought by Klipstein and a sale held, but alleged that the reasonable value of the stock of goods sold was $1,900.00; denied that any actions were taken by either Stelzner or Klipstein with the intent to hinder, defraud or delay creditors.

Klipstein, also answering separately [Tr. p. 11; also p. 21], admitted that the corporation *had filed its articles* but denied that it was otherwise at any time duly organized or existing; denied that Klipstein was ever a stockholder, director or officer of the corporation; admitted the bankruptcy and the appointment of Sears as trustee; admitted the loan from the bank *to Stelzner* but denied that any part thereof was received by Klipstein, or that any stock was purchased for him; alleged that Klipstein signed the note as an accommodation party only and *received no consideration at any time for his signature;* admitted that certain payments were made on the note, the amounts of which were unknown to him, but denied that the payments were made from corporate funds; denied that the purported corporation had creditors and denied

that the purported corporation was insolvent at the time of making any such payments; denied that the drug company received no consideration for such payments; denied that such payments were made for the purpose of hindering, delaying or defrauding creditors; admitted that a note was given by the purported corporation to the bank on October 19, 1935; admitted that a suit was brought by Klipstein against the corporation but denied that said suit was brought for any fraudulent purpose and denied that the assets sold were of the value of $5,000.00; denied that the corporation was insolvent on October 19, 1935; denied for lack of information and belief that the corporation had creditors still unpaid and that there were insufficient assets to pay such creditors in full; pleaded the statute of limitations and alleged that Sears was estopped from any claim against Klipstein.

The suit was tried by the court, a jury having been waived, upon the issues raised by the amended bill and the respective answers of the defendants Stelzner and Klipstein. At the trial the only evidence introduced by complainant was the testimony of Stelzner, C. H. Landes (an officer of Bank of America) and Richard A. Pawson (a representative of a creditor of the corporation), and certain exhibits. On behalf of the defendants there was produced the testimony of Klipstein and Sears and several exhibits. There were no conflicts in the evidence, which undisputedly shows the following state of facts:

Articles of Incorporation of Globe Drug Company, Inc., were filed with the Secretary of State of the state of California on July 17, 1920, by Stelzner, V. J. Moore and James F. Brazill. The authorized capital stock of the corporation was 25,000 shares of a par value of $1.00 per share. The board of directors was to consist of three (3) members. [Tr. pp. 52-53.]

No permit to issue any such shares was at any time granted to the corporation by the Commissioner of Corporations of the state of California. [Tr. pp. 57, 64.]

Some time prior to January 3, 1928, an agreement was reached among Stelzner, Moore and one G. D. Holmquist, the then sole stockholders, by which Stelzner was to buy out the interests of Moore and Holmquist for the sum of $17,000.00. Klipstein, Stelzner's brother-in-law, agreed to aid Stelzner in raising the necessary funds. [Tr. pp. 55, 60.]

On January 3, 1928, the sum of $17,000.00 was borrowed by Stelzner from Bank of America, at Bakersfield. A note for that amount was signed and Klipstein affixed his signature to the note as an accommodation maker. [Tr. pp. 55, 57.] The stock held by the other parties was purchased by Stelzner and the certificates placed in the name of Klipstein. [Tr. p. 55.] At the same time proceedings were held to make Klipstein an officer and director of the drug company. At stockholders and directors meetings on December 31, 1927, Klipstein was purportedly elected a director and vice-president, and at a directors meeting on January 4, 1928, purportedly elected secretary. [Tr. p. 53.] Klipstein never at any time received any consideration for placing his signature on the note. [Tr. pp. 57, 60.]

No meetings of directors or stockholders were held for the next ensuing seven years, that is between January 23, 1928, and October 19, 1935. [Tr. pp. 53, 62.] During this period Stelzner was in sole charge of the drug store and Klipstein, who was in the title business, took no part and had no interest therein. [Tr. pp. 57, 60.] Between these dates payments of principal and interest on the loan were made by Stelzner to the bank. All such payments,

with the exception of $500.00 paid in 1934, were made from the funds of the drug company, which received no consideration therefor. [Tr. pp. 55, 61.] On each of the dates when any such payment was made the drug company was indebted to McKesson & Robbins, a wholesale drug concern, in at least the amount paid on the principal of the loan, on open credit account. [Tr. pp. 48-51.]

On October 19, 1935, the balance due on the principal of the loan was $4,800.00. [Tr. p. 44.] Several months prior to this date Klipstein first learned that Stelzner had unpaid creditors. [Tr. p. 60.] Klipstein thereupon consulted his attorneys at Bakersfield as to what should be done. [Tr. p. 62.] Pursuant to their advice the following steps were taken. On October 19, 1935, Klipstein demanded that the drug company execute a note to the bank in the sum of $4,800.00. A meeting was held on that day and the note was authorized, executed and delivered to the bank. Klipstein thereupon delivered his personal note in such amount to the bank in exchange for the drug company's note, which personal note was subsequently paid in full by Klipstein from his personal funds. [Tr. pp. 60-63.]

A suit was immediately commenced by Klipstein against the drug company for the amount of the note and $500.00 which he had paid to the bank in 1934. [Tr. p. 56.] This action was brought without prior notice to Stelzner for the purpose of preventing a further loss to the drug company, which at the time was unable to pay its rent, had a depleted stock and was losing money from day to day. [Tr. pp. 56, 61.]

Stelzner, believing there was no defense, defaulted. [Tr. p. 56.] Judgment was entered, execution issued and the stock and fixtures, which prior to the sale had been

appraised by a druggist at $2,200.00, were sold at public sale by the sheriff to Mr. Vest, an outsider, for $1,935.00. [Tr. pp. 58, 61.] The proceeds of the sale, less costs and expenses, were held by Klipstein's attorneys for the benefit of creditors and subsequently paid to Sears. [Tr. p. 58.] Creditors were notified of the proceedings by letters sent by Sears to the Board of Trade at San Francisco and the Los Angeles Wholesalers' Board of Trade. [Tr. pp. 64-65.] Klipstein instructed his attorneys to file a claim based on this judgment in the bankruptcy proceedings and to waive the claim at the meeting of creditors. [Tr. p. 61.]

During all of the period in consideration, and at the trial, Klipstein was unable to recognize the legal distinction between Stelzner as an individual and the drug company as a corporate entity. Klipstein regarded himself as a creditor of the corporation as well as of Stelzner and considered the judgment against the drug company as a judgment against Stelzner. [Tr. pp. 61-63.] Stelzner shared this belief. [Tr. p. 56.]

Globe Drug Company, Inc., was adjudicated a bankrupt on March 6, 1936, and Sears appointed trustee of its estate on April 18, 1936. This suit was commenced on October 20, 1936.

After trial by the court a decision in favor of Sears was announced by minute order made on December 4, 1937 [Tr. p. 24], and on December 29, 1937, the court made special findings and entered its decree [Tr. pp. 26-33], which decree was modified by a further order made on April 2, 1938. [Tr. pp. 36-37.] Stelzner has not appealed. [Tr. p. 68.]

This appeal was taken by Klipstein from the decree of the trial court, as amended. Being an equity appeal the

whole case is before the appellate court for decision on the merits, giving due weight to the findings of fact made by the trial judge. More particularly the questions to be considered arise from the exceptions taken below to (1) the findings of fact on the ground that certain designated and material findings are unsupported by any substantial evidence, (2) to the decree on the ground that it is unsupported by the evidence and the findings and (3) to the decree on the ground that such decree is void upon its face. These objections were made to the trial court and the fact thereof noted by the allowance of exceptions to the findings of fact and conclusions of law at the foot thereof and a further allowance of exception noted at the foot of the decree, as amended.

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SPECIFICATIONS OF ERRORS RELIED UPON.

SUMMARY OF ARGUMENT.

A. The appellate court in an appeal from a decree entered in an equity suit has before it both the facts and the law. It may consider the evidence supporting the findings and decree and may finally dispose of the case in accordance with its view of such evidence. Due weight is to be given to the findings made by the trial court but the appellate court is not bound by the findings, when clearly contrary to the weight of the evidence. This is true even in cases where there is substantial evidence in support of such findings.

B. There is no substantial evidence to support, in whole or in part, certain material findings of fact made by the trial court. Such findings are:

1. Finding of Fact. No. III [Tr. p. 27]
2. Finding of Fact No. IV [Tr. p. 27]
3. Finding of Fact No. II [Tr. p. 26]
4. Finding of Fact No. VIII [Tr. p. 29]
5. Findings of Fact Nos. V, VI and VII [Tr. pp. 28-29], considered as a group.

C. Complainant's substantive rights under the cause of action asserted in his amended bill are governed exclusively by the statutes and decisions of the state of California.

1. The evidence does not support the decree under the California law relating to fraudulent transfers for the

reasons that (a) there is no evidence of a transfer within the meaning of such law, (b) there is no evidence and no finding of actual fraud on the part of Klipstein, and (c) there is no evidence that the drug company was insolvent at any time prior to the date of the adjudication in bankruptcy.

2. The evidence does not support the decree under the California law relating to the liabilities of directors and officers of corporations for the reasons that (a) the undisputed evidence shows that Klipstein was never a *de jure* officer or director of the drug company and there is no substantial evidence that he was a *de facto* officer or director, and (b) there is no evidence that there were creditors existing at the time of the alleged transfers whose claims equal the amount of the decree and are still unpaid.

D. The decree is not supported by the findings in that there is no finding that any creditors have proved their claims in the bankruptcy proceedings and remain unpaid.

E. The decree entered is void in that the extent of Klipstein's liability is made thereby to depend upon a report made by a referee in a proceeding in which Klipstein is not represented and has no standing to dispute the propriety of any items in such report.

ARGUMENT.

The appellate court in an appeal from a decree entered in an equity suit has before it both the facts and the law. It may consider the evidence supporting the findings and decree and may finally dispose of the case in accordance with its view of such evidence. Due weight is to be given to the findings made by the trial court but the appellate court is not bound by the findings, when clearly contrary to the weight of the evidence. This is true even in cases where there is substantial evidence in support of such findings.

This action is in equity and was so pleaded and tried. The scope of the appellate court's review on an appeal from a final decree entered in an equity action has been stated by the Supreme Court in the case of *Keller v. Potomac Electric Power Company*, 261 U. S. 428, 43 S. Ct. 445 (1923), to be as follows:

> "In that (equity) procedure, an appeal brings up the whole record and the appellate court is authorized to review the evidence and make such order or decree as the Court of first instance ought to have made, giving proper weight to the findings on disputed issues of fact which should be accorded to a tribunal which heard the witnesses."

In accord with this statement are the cases of:

Presidio Mining Company v. Overton, 270 Fed. 388 (C. C. A. 9th, 1921);

Title Guarantee & Trust Company v. United States, 50 Fed. (2d) 544 (C. C. A. 9th, 1931);

Johnson v. Umsted, 64 Fed. (2d) 316 (C. C. A. 8th, 1933);

Aro Equipment Corporation v. Herring-Wissler Company, 84 Fed. (2d) 619 (C. C. A. 8th, 1936).

This rule has not been changed by the adoption, in 1930, of Equity Rule 70½, requiring the separate statement of findings of fact and conclusions of law. The effect of the new equity rule is merely to give the findings made by the trial court on disputed questions of fact the presumption of correctness. See *Broughton & Wiggins Navigation Company v. Hammond Lumber Company,* 84 Fed. (2d) 496 (C. C. A. 9th, 1936), construing the identically worded admiralty rule (Admiralty Rule 46½); *Hyland v. Miller's National Insurance Company,* 91 Fed. (2d) 735 (C. C. A. 9th, 1937).

Due to the undisputed character of all of the testimony in the case at bar this court is free to make whatever disposition of the cause appears to it just, accepting or rejecting the theories indulged in by the trial court. The basis of that court's decision is disclosed in its order directing judgment for plaintiff in which it "finds in favor of the plaintiff and (upon the authority of *In re Wright Motor Company* (C. C. A. 9th, 1924), 299 Fed. 106) orders a decree, etc." [Tr. p. 24.]

In so doing the court, as appellant respectfully contends, indulged in either one or the other of the following untenable theories, namely:

(a) that the question involved was one of general law as to which the court was not bound by the statutes and decisions of the state of California, or

(b) that the law of California had remained unchanged since the date of the *Wright Motor Company* case (1924) and that under such law complainant was not required to establish by evidence such material facts as the insolvency of the drug company at any time prior to its adjudication in bankruptcy or the existence of creditors still unpaid whose claims antedate the alleged withdrawals.

It may be noted in passing that the order referred to was entered on December 4, 1937, prior to the overruling of *Swift v. Tyson,* 41 U. S. 1, 10 L. Ed. 865 (1842), by the decision of the Supreme Court of the United States in *Erie Railroad Company v. Tompkins,* 304 U. S. 64, 58 S. Ct. 817, decided in April of 1938. The *Erie Railroad Company* case has the result of rendering decisions of the federal courts on general law questions no longer authoritative and limits the substantive law administered by such courts to the substantive law of the state in which the particular cause arose. As will be pointed out in this brief the applicable California laws were not followed in deciding this case. In addition to the wholly different factual set-up involved in the *Wright Motor Company* case the statutory and constitutional provisions upon which that case was based had been entirely changed before the occurrence of events involved in the case at bar.

Assignment of Error No. XIII.

There is no substantial evidence to support finding of fact No. III, upon the issues raised by the amended bill, paragraph III [Tr. p. 6], and Klipstein's answer, paragraph III [Tr. p. 11], assigned as error on this appeal as follows [Tr. p. 80]:

> "The Court erred in making and entering its Finding of Fact Number III, as follows:
>
> 'That on January 3, 1928, the defendants Lew O. Stelzner and T. E. Klipstein borrowed the sum of $17,000.00 from the Bank of America, and in consideration of such loan executed to such bank their personal joint and several promissory note for the same; that said sum of $17,000.00 was thereupon used by said defendants for the purpose of purchasing certain issued and outstanding shares of said Globe Drug Company, Inc., for their own personal and individual accounts.'; to which said finding an exception in favor of defendants was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.
>
> For the reason that there is no competent evidence in the record to support such finding."

There is no evidence whatever that Klipstein ever borrowed the sum of $17,000.00 or any other sum from Bank of America or that Klipstein ever used any money borrowed by Stelzner or anyone else from the bank for the purpose of purchasing shares of Globe Drug Company, Inc., for his account. The evidence indisputably shows that the sum mentioned was borrowed by Stelzner, that Stelzner purchased the stock, that Klipstein's signature on the note at the bank was made for accommodation

only and that the shares purchased were placed in Klipstein's name as security only.

Mr. Landes, an officer of the bank, called as a witness by Sears, testified that the bank records showed a loan to Stelzner, evidenced by a note "endorsed or secured" by the signature of Klipstein. [Tr. p. 39.] Photostatic copies of the bank records in question, introduced into evidence as Plaintiff's Exhibit 3 [Tr. p. 44], corroborate Mr. Landes and show that the loan account was carried in the name of Stelzner only and that in the margin of said account there was a notation that the account was "endorsed or secured" by Klipstein.

Stelzner testified that the note was signed by Klipstein as a personal accommodation to Stelzner and that Klipstein never received any part of the money borrowed or anything else for his accommodation. [Tr. p. 57.] Concerning the purchase of the stock Stelzner testified that "I received the proceeds of said loan and used the same to buy the stock * * *" [Tr. p. 55], and Stelzner subsequently referred to the shares as "the stock that I bought." [Tr. p. 56.]

Klipstein testified that in 1928 he "aided" Stelzner in procuring the money from the bank "to buy out his partners." [Tr. p. 60.] Klipstein further testified that the money was received by Stelzner and that Klipstein never at any time received any consideration of any kind for placing his name on the note. [Tr. p. 60.]

This was the only evidence produced on the issue as to the intention of the parties in regard to the stock placed in the name of Klipstein on the books of the drug company. It is perfectly obvious that the stock purchased was purchased by Stelzner from money which Stelzner borrowed, that Klipstein's entire connection with the trans-

action was in the character of a guarantor and that the stock was put in his name for security only, as alleged in Stelzner's answer. [Tr. p. 16.] There was no evidence nor can the inference be drawn from any evidence in the record that it was ever at any time the intention of either Stelzner or Klipstein that Klipstein should be beneficially interested to any extent in the shares purchased.

Assignment of Error No. XIV.

There is no substantial evidence to support finding of fact No. IV upon the issues raised by the amended bill, paragraph IV [Tr. p. 6], and Klipstein's answer, paragraph IV [Tr. p. 12], assigned as error on this appeal as follows [Tr. p. 80]:

> "The Court erred in making and entering its Finding of Fact Number IV, as follows:
>
> 'That during the period of time from the execution of said note up to October 19, 1935, various payments were made on account of the principal and interest of said note, aggregating a sum in excess of $12,200.00; that all of such payments were made by, and directly from and with the funds of, said corporation; that at each and all of the times when said payments were made as aforesaid, said corporation owed various sums of money to various creditors, such indebtedness at such times being in excess of the amounts of such respective payments; that no consideration whatsoever was ever received by said corporation for or in connection with any of said payments; that for a period of at least three years prior to the date of its adjudication in bankruptcy, said corporation was in an insolvent condition; that

the payments made by said corporation on the personal note of said defendants during said three-year period aggregated a sum of at least $4,255.54; that each and all of said payments were made as aforesaid with the purpose and intent on the part of said corporation, and of said defendants, of hindering, delaying, and defrauding the creditors of said corporation.'; to which said finding an exception in favor of defendant was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.

For the reason that there is no competent evidence in the record to support such finding."

The only evidence in the record in any way bearing upon the finding "that at each and all of the times when said payments were made as aforesaid, said corporation owed various sums of money to various creditors, such indebtedness at such times being in excess of such respective payments;" is the testimony of Mr. Pawson, assistant credit manager of McKesson & Langley, who prepared lists [Complainant's Exhibit 4, Tr. p. 48], showing the debit balance of Globe Drug Company, Inc. on the books of McKesson & Langley on the various dates when payments of principal and interest were made to the bank. [Tr. p. 45.] The testimony and the exhibit shows only that the drug company during a period of some seven and a half years maintained an open credit account with *one* wholesale drug concern and that the average balance in said account during that period was around $1,000.00. There is no evidence in the record that the drug store had any other creditors during this period, so that the finding that there were "various creditors" is absolutely unsupported. This lack of evidence is very important to appel-

lant because appellee's rights in this action are limited to the rights of creditors whom he represents. *Davis v. Willey,* 273 Fed. 397 (C. C. A. 9th, 1921).

Sears pleaded in his amended bill that the drug store was insolvent from date of the execution of the note (January 3, 1928) to October 19, 1935 [paragraph IV, Tr. p. 6], which allegation was specifically denied by Klipstein in his answer. [Paragraph IV, Tr. p. 12.] The court found that "for a period of at least three years prior to the date of its adjudication in bankruptcy, said corporation was in an insolvent condition."

There is an absolute lack of evidence to sustain any such finding. The only proof in the record in any way relevant to this issue is: (1) Mr. Pawson's testimony that the drug store was indebted to McKesson & Langley on open account during the entire period [Tr. p. 45]; (2) Klipstein's admission in his answer [paragraph I, Tr. p. 11], of complainant's allegation in its amended bill [paragraph I, Tr. p. 5] that Globe Drug Company, Inc., was adjudicated a bankrupt in the month of April, 1936; and (3) Klipstein's testimony that he first learned that there were "unpaid creditors" [Tr. p. 60], a few months prior to the filing of the Kern County action, *i. e.,* prior to October 19, 1935. [See Complainant's Exhibit 7, Tr. p. 56.]

There is no further evidence bearing in any way upon the financial standing of the company at any time during the period of the withdrawals. This evidence without more is obviously insufficient to establish the fact of insolvency for any three-year or other period prior to the date of the adjudication in bankruptcy.

Appellant will not here argue the sufficiency of the evidence to support the finding that "each and all of said payments were made as aforesaid with the purpose and

intent on the part of said corporation and of said defendants, of hindering, delaying and defrauding the creditors of said corporation." It is appellant's contention in this regard that this and certain other findings containing similar language must be interpreted in view of the findings as a whole in order to determine the intent of the trial court in making such findings. Appellant will therefore reserve his argument on this point for a later part of his brief.

Assignment of Error No. XII.

There is no substantial evidence to support finding of fact No. II, on the issues raised by the amended bill, paragraph II [Tr. p. 6], and the amendment to Klipstein's answer, paragraph I [Tr. p. 21], assigned as error on this appeal as follows [Tr. p. 79]:

> "The Court erred in making and entering its Finding of Fact Number II as follows:
>
> 'That at all times herein mentioned said Globe Drug Company, Inc., was a corporation duly organized and existing under and by virtue of the laws of the State of California; that ever since January 3, 1928, the defendant Lew O. Stelzner was a stockholder, the president and one of the members of the Board of Directors of said corporation and the defendant T. E. Klipstein was a stockholder, the secretary, and one of the members of the Board of Directors of said corporation.';
>
> to which said finding an exception in favor of defendant was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.
>
> For the reason that there is no competent evidence in the record to support such finding."

The point raised in this assignment of error will be discussed at some length *infra* in the argument addressed to the question of the propriety of the decree under the California law relating to liabilities of directors and officers of corporations.

In view of the evidence of Stelzner [Tr. p. 57] and the Commissioner of Corporations [Tr. p. 64] that no permit to issue stock was ever procured, Klipstein never became a *de jure* director or officer under the California law then in effect.

> *General Laws of California* (Deering, 1923), Act 3814, Sec. 12;
>
> *Klinker v. Guarantee Title Co.,* 98 Cal. App. 469, 277 Pac. 177 (1929);
>
> *Regan v. Albin,* 219 Cal. 357, 26 Pac. (2d) 475 (1933).

Moreover there was no evidence whatever of any acts which might make Klipstein a *de facto* officer during the period of the withdrawals. The first payment to the bank was on April 3, 1928 [Tr. p. 41], the last on August 9, 1935. [Tr. pp. 40, 42.] There is absolutely no evidence that Klipstein ever attended any meeting, or signed any documents, or authorized or consented to any withdrawal, or otherwise in any manner whatsoever took any part in the management or business of the drug store from January 23, 1928, to October 19, 1935. There is therefore no evidence of any kind from which it could be inferred that Klipstein was a *de facto* officer or director of the corpora-

tion during any part of the period in which the acts complained of occurred.

> "One in actual possession of an office under claim and color of election or appointment, and *continually exercising its functions and discharging its duties*, is an officer *de facto*."
>
> Fletcher, Cyclopedia of Corporations (Perm. Ed. 1931), Vol. 2, p. 145.

Assignment of Error No. XVIII.

There is no substantial evidence to support finding of fact No. VIII, upon the issues raised by the amended bill, paragraph II [Tr. p. 9] and Klipstein's answer, paragraph X [Tr. p. 13], assigned as error on this appeal as follows [Tr. p. 83]:

> "The Court erred in making and entering its Finding of Fact Number VIII, as follows:
>
> 'That the payments made out of said corporation's funds as aforesaid, were authorized and consented to by the defendants while they were acting as officers and directors of said corporation, and while they were stockholders thereof; that said payments were not made out of surplus or net profits of said corporation, nor was said corporation then in the process of winding up or dissolution; that said payments were made without the vote or written consent of any of the shares of said corporation other than the shares held by the defendants; that no permit of the Commissioner of Corporations of the State of California was ever applied for or issued authorizing such payments'; to which said finding an exception in favor of de-

fendant was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.

For the reason that there is no competent evidence in the record to support such finding."

There is not one word of evidence that Klipstein ever "authorized" or "assented to" any withdrawal of corporate funds, or that he even knew or suspected the source from which Stelzner procured the money to pay the bank. Neither was there any word of evidence from which a finding could be made that such payments were not made from net surplus. It is impossible for any court to say, on the record in this case, at what time, if ever, the capital stock of the drug company became impaired prior to October, 1935. In these respects finding of fact No. VIII is absolutely and completely unsupported.

Assignments of Error Nos. XV, XVI & XVII.

There is no substantial evidence to support findings of fact Nos. V, VI and VII upon the issues raised by the amended bill, paragraphs V, VI and VII [Tr. pp. 7, 8], and Klipstein's answer, paragraphs V, VI and VII [Tr. p. 12], assigned as errors on this appeal as follows [Tr. pp. 81-83]:

Assignment of Error No. XV.

"The Court erred in making and entering its Finding of Fact Number V, as follows:

'That on or about October 19, 1935, there remained unpaid on the principal of said promissory note a balance of $4,800.00; that on or about said date defendants, acting as directors and officers of said corporation, caused to be executed to said Bank of

America the promissory note of said corporation in the sum of $4,800.00; that said note was thereupon accepted by said bank in payment of the balance due on said promissory note of the defendants; that said corporation received no consideration for the execution of said note; either directly or indirectly.';

to which said finding an exception in favor of defendant was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.

For the reason that there is no competent evidence in the record to support such finding."

ASSIGNMENT OF ERROR NO. XVI.

"The Court erred in making and entering its Finding of Fact Number VI, as follows:

'That shortly after the execution of said last mentioned promissory note, the defendant Klipstein purchased the same from said bank and thereupon, and on October 19, 1935, commenced an action in the Superior Court of the State of California, in and for the County of Kern, to recover from said corporation the amount alleged by him to have been so paid in the purchase of said note; that thereafter the

illegally and without right or cause [LRY]

defendants, ~~fraudulently~~ permitted said corporation to suffer a default judgment to be entered in said action against it for the sum of $5,364.00; that thereafter execution was issued on said judgment, pursuant to which all of the properties and assets of said corporation were sold at public auction by the sheriff of said county.';

to which said finding an exception in favor of defendant was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.

For the reason that there is no competent evidence in the record to support such finding."

ASSIGNMENT OF ERROR NO. XVII.

"The Court erred in making and entering its Finding of Fact Number VII, as follows:

'That at the time said action was commenced and said execution sale was effected as aforesaid, said corporation owed various sums of money to various creditors and was insolvent, and said action was commenced and prosecuted, such judgment was suffered to be taken, and said execution sale effected with the purpose and intent on the part of said corporation and the defendants of hindering, delaying, and defrauding the creditors of said corporation.';

to which said finding an exception in favor of defendant was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.

For the reason that there is no competent evidence in the record to support such finding."

The three assignments of error above set out deal as a group with the action brought by Klipstein in the Superior Court of the state of California for Kern county. Most of the facts stated in these three findings are in accordance with the undisputed evidence produced. The finding that the corporations owed various sums of money to various creditors and was insolvent on the date that judgment was entered in that action has already been considered in connection with Assignment of Error No. XIV, *supra*. The finding that the sale was made for the purpose of hindering, delaying and defrauding creditors and the legal conclusion that the default was suffered "illegally and without

right or cause" will be considered below in connection with the question of intent expressed by the findings as a whole.

Appellant desires to raise the question of these three assignments of error as a group because they relate to a phase of the case that is absolutely irrelevant to the relief granted by the trial court. It is appellant's belief that these findings are unsupported in the particulars above mentioned but that these findings whether supported or not have no bearing on the case. No one was injured by the execution of the corporate note—the note was never paid and was returned to the company. [Tr. p. 61.] No one was injured by the judgment—nothing was ever paid on it. [Tr. p. 62.] No one was injured by the execution sale—the proceeds were turned over to Sears, as trustee, and there is no hint in the record that the sales price was not absolutely fair. [Tr. pp. 58, 62.] As a matter of fact Klipstein's testimony that the creditors in fact benefited by the whole proceeding was undisputed. [Tr. p. 61.] Whether Klipstein had any right of action against the company depends on the law of *alter ego*. It is obvious that he believed he had such a right and Stelzner himself shared this belief. [Tr. pp. 63, 56.] Klipstein's action was undoubtedly taken as the result of poor advice by his then attorneys, who should have known that such a suit would appear improper to creditors even if brought for the purpose of preventing Stelzner from further depleting the assets of the corporation. Klipstein's good faith in the matter is conclusively shown, however, and since there is no evidence that the corporation was in any way injured the findings based on this phase of the case are irrelevant and unnecessary. Appellant does not believe that appellee will attempt to use any portions of such findings to sustain the decree. In fairness they should be stricken as needlessly coloring the record.

Complainant's substantive rights under the cause of action asserted in his amended bill are governed exclusively by the statutes and decisions of the state of California.

The jurisdiction of the court below was invoked, and could only be invoked, under section 70(e) of the National Bankruptcy Act as it existed at the time when suit was brought (Act of July 1, 1898, c. 541, §70(e), 30 Stat. 565, as amended by Act of Feb. 5, 1903, c. 487, §16, 32 Stat. 800, U. S. C. A. (1928), Title 11, §110 (e)). Diversity of citizenship was neither pleaded nor proved so that the claimed jurisdiction must rest within the exceptions, stated in section 23(b) of the Act, to the general rule that the trustee, except with the consent of the proposed defendants, may only sue in the federal courts in which the bankrupt could have sued had bankruptcy not intervened. See *Wood v. A. Wilbert's Sons Shingle & Lumber Company*, 226 U. S. 384, 33 S. Ct. 184 (1912). There is of course no question of consent in this case. [See Assigned Error No. I, Tr. p. 71.]

The only actions excepted from the general rule by the express provisions of section 23(b) are those brought for the recovery of property under sections 60(b), 67(e) and 70(e). Both 60(b) and 67(e) relate solely to actions brought to invalidate certain enumerated transactions occurring within four months of the bankruptcy. Since in the case at bar all transfers are conceded to have been made more than four months prior to the bankruptcy it is obvious that jurisdiction can only be sustained, if at all, under section 70(e). If appellee on this appeal should attempt to sustain the decree under any other section of the Bankruptcy Act he would automatically forfeit his right to claim that the court below had jurisdiction.

Section 70(e) of the National Bankruptcy Act, in effect during the entire period under consideration, was as follows:

> "e. The trustee may avoid any transfer by the bankrupt of his property which any creditor of such bankrupt might have avoided, and may recover the property so transferred, or its value from the person to whom it was transferred, unless he was a bona fide holder for value prior to the dates of the adjudication. Such property may be recovered or its value collected from whoever may have received it, except a bona fide holder for value. For the purpose of such recovery any court of bankruptcy as hereinbefore defined, and any State court which would have had jurisdiction if bankruptcy had not intervened, shall have concurrent jurisdiction."

It is well settled that this section does not confer upon the trustee in bankruptcy any substantive rights in addition to those which creditors would have possessed had bankruptcy not intervened. See:

Stellwagen v. Clum, 245 U. S. 605, 38 S. Ct. 215 (1918);

Davis v. Willey, 273 Fed. 397 (C. C. A. 9th, 1921);

Peter Barceloux Company v. Buffum, 61 Fed. (2d) 145 (C. C. A. 9th, 1932), reversed on other grounds *sub nom. Buffum v. Barceloux,* 289 U. S. 227, 53 S. Ct. 539 (1933).

In the case last cited the Circuit Court of Appeals states:

> ". . . it has been uniformly held that this provision (section 70e) of the Bankruptcy Act does not give any substantive right in cases of transfer made

more than four months before the institution of the bankruptcy proceeding, but merely authorizes the trustee to enforce the rights of creditors in accordance with the laws of the state applicable to the transaction."

Since all the transactions involved in this case took place entirely within the state of California and no extra-state contacts were involved, the rights of creditors seeking to secure the relief which the trustee is now asking depend upon the substantive law of the state of California as contained in its statutes and decisions. This would of course be true in any action brought by a creditor in the state courts and would be true as well in any similar action in the federal courts, which are bound to follow both the statutes and decisions of the state. (See Act of September 24, 1789, c. 20, §34, 1 Stat. 92, U. S. C. A. (1928), Title 11, §725; *Erie Railroad Company v. Tompkins,* 304 U. S. 64, 58 S. Ct. 817 (1938).)

Assignment of Error No. XXI. [Tr. p. 85.]

"The Court erred in making and entering its Conclusion of Law Number I, as follows:

'That all the payments made out of said corporation's funds as above described, were wrongfully and [LRY] in law illegally made, and were and are fraudulent ∧ and void as to plaintiff.'

to which said conclusion of law an exception in favor of defendant was duly allowed and noted at the foot of the Findings of Fact and Conclusions of Law.

For the reason that such conclusion of law is not supported by the evidence or by the facts found."

Assignment of Error No. XXIV. [Tr. p. 87.]

"The Court erred in making and entering its decree, as amended, for the reason that there is no substantial evidence to sustain said decree."

The California law applicable to this case is contained in two groups of statutory provisions, together with the decisions of the California courts construing these provisions. These are, first, the provisions relating to the rights of creditors to set aside fraudulent transfers, and, second, the provisions relating to the liability to creditors of directors and officers of corporations. It is obvious that Sears' amended bill was drawn in two counts with this distinction in mind. The first count [Tr. pp. 5-8] alleges the transfer of funds from the bankrupt with intent to defraud creditors, made without consideration, while the bankrupt was insolvent. The second count [Tr. pp. 8-9] alleges a violation of the statutory duties of officers and directors of corporations.

The evidence does not support the decree under the California law relating to fraudulent transfers for the reasons that (a) there is no evidence of a transfer within the meaning of such law, (b) there is no evidence and no finding of actual fraud on the part of Klipstein, and (c) there is no evidence that the drug company was insolvent at any time prior to the date of the adjudication in bankruptcy.

The law of California relating to the rights of creditors to invalidate transfers made by a debtor is contained in sections 3439 and 3442 of the Civil Code, as follows:

"§3439. Every transfer of property or charge thereon made, every obligation incurred, and every judicial proceeding taken, with intent to delay or de-

fraud any creditor or other person of his demands, is void against all creditors of the debtor, and their successors in interest and against any person upon whom the estate of the debtor devolves in trust for the benefit of others than the debtor."

"§3442. In all cases arising under section twelve hundred and twenty-seven, or under the provisions of this title, except as otherwise provided in section thirty-four hundred and forty, the question of fraudulent intent is one of fact and not of law; nor can any transfer or charge be adjudged fraudulent solely on the ground that it is not made for a valuable consideration; provided, however, that any transfer or encumbrance of property made or given voluntarily, or without a valuable consideration, by a party while insolvent or in contemplation of insolvency, shall be fraudulent, and void as to existing creditors."

The elements of the creditors' cause of action as provided for in these sections is clear. There must occur, first, a transfer of a property right and, second, fraud, either actual or constructive, the latter being treated as a conclusive presumption resulting from a showing of no consideration plus insolvency. See, *Hopkins v. White,* 20 Cal. App. 234, 128 Pac. 780 (1912).

The first question to be considered is whether there is any evidence of a "transfer" within the meaning of the statutory provisions. There is no dispute as to the mechanics of the transactions in question. Corporate funds were paid out on corporate checks signed by Stelzner, to the order of the bank. [Tr. p. 43.] These funds were applied upon a personal indebtedness of Stelzner to the bank, for which Klipstein was secondarily liable as surety. [Tr. p. 44.]

For reasons best known to himself Sears has not sought to impose liability upon the real transferee of the corporate assets, the bank. Instead he seeks to hold Klipstein, who was scarcely more than an outsider in the whole transaction. The bank was the party primarily benefited in that the money borrowed from it was repaid. Stelzner benefited directly by the cancellation of his personal and primary obligation. Klipstein's benefit was wholly incidental in that the cancellation of Stelzner's primary obligation extinguished *pro tanto* Klipstein's contingent liability to pay the bank if Stelzner defaulted on an obligation created wholly for Stelzner's benefit. No money or property passed to Klipstein at the time of the original loan, or at the time of the asserted "transfers."

California decisions go further than the decisions in a majority of the other states in imposing liability upon a fraudulent transferee who has re-transferred the property received by him, on the theory that the proceeds of such re-sale create a trust fund. (See *Pedro v. Soares,* 18 Cal. App. (2d) 600, 64 Pac. (2d) 766 (1937), and cases cited therein.) But no California case known to appellant goes so far as to make liable a party who *has never had in his hands any cash or property transferred by the debtor.* This was the position of Klipstein. Even under the most liberal trust rules there was here no fund, no property nor anything else ever in the hands of Klipstein to which a trust might attach.

In addition to a transfer, the creditor invoking sections 3439 and 3442 must prove fraud, either actual under section 3439 or constructive under section 3442. Constructive fraud is shown when there is a lack of consideration for a transfer made at a time when the transferor is insolvent or contemplates insolvency, and renders the trans-

action void as to existing creditors only. Intent is here immaterial.

Atkinson v. Western Development Syndicate, 170 Cal. 503, 150 Pac. 360 (1915);

Hanscome-James-Winship v. Ainger, 71 Cal. App. 735, 236 Pac. 325 (1925).

Appellant does not believe that appellee will claim on this appeal that the trial court found Klipstein guilty of actual fraud under these statutory provisions. Actual fraud means an actual intent or design in the mind of Klipstein to prevent creditors of the corporation from reaching its assets.

Ross v. Sedgwick, 69 Cal. 247, 10 Pac. 400 (1886);

Goldner v. Spencer, 163 Cal. 317, 125 Pac. 347 (1912).

The court found that the payments made to the bank were made "with the purpose and intent on the part of said corporation, and of said defendants, of hindering, delaying, and defrauding the creditors of said corporation." [Finding of Fact No. IV, Tr. p. 28]; as to the suit by Klipstein against the drug company that "said action was commenced and prosecuted, said judgment was suffered to be taken, and said execution sale effected the purpose and intent on the part of said corporation and the defendants of hindering, delaying, and defrauding the creditors of said corporation." [Finding of Fact No. VII, Tr. p. 29.] *But* the court in Finding of Fact No. VI [Tr. p. 28] found not that the default judgment was fraudulently permitted to be entered but that this was done "illegally and without right or cause" and for its

general conclusion drawn from all of the findings of fact the court concluded "That all the payments made out of said corporation's funds as above described, were wrongfully and illegally made, and were and are fraudulent *in law* and void as to plaintiff." [Conclusion of Law No. I, Tr. p. 30.]

It is obvious that the findings and conclusions must be construed together in order to determine the intent of the trial court. That intent is clear from the phraseology of the findings and conclusions and from the only opinion rendered, that contained in the minute order of December 4, 1937, wherein the court held the defendants liable in the sum of $4,255.54," the same being the sums shown to have been illegally withdrawn and paid out by the defendants and for which they are liable to account to the plaintiff." [Tr. p. 25.]

A consideration of the law and the evidence will show indisputably that the trial court could not have intended to find otherwise on this issue. In the early case of *Dana v. Stanfords,* 10 Cal. 269 (1858), the Supreme Court of California stated:

> "To avoid the conveyance (i. e. on the ground of actual fraud), there must be a real design on the part of the debtor to prevent the application of his property, in whole or in part, to the satisfaction of his debts."

This language was cited and approved after the adoption of the codes in *Ross v. Sedgwick,* 69 Cal. 247, 10 Pac. 400 (1886).

All presumptions are against actual fraud and must be overcome by clear and convincing evidence before warranting a finding. *Levy v. Scott,* 115 Cal. 39, 46 Pac.

892 (1896). In the case of *Truett v. Onderdonk,* 120 Cal. 581, 53 Pac. 26 (1898), the court stated in this connection:

> "The presumption is always against fraud, a presumption approximating in strength to that of innocence of crime, and it should not be deemed overcome, even *prima facie,* upon a showing so intangible and shadowy."

It is sufficiently obvious that there is no proof in the record of this case sufficient to establish actual fraud under the stringent California requirements. In the first place the most Sears could possibly claim under any circumstances is that Klipstein should have known the source of the payments, should have determined their legal impropriety and should have taken active steps to prevent Stelzner from making further payments. There is no evidence whatsoever that Klipstein had any connection of any sort with the affairs of the corporation between January 23, 1928 and October 19, 1935. [Tr. pp. 53, 57, 62.] January 23, 1928, was *prior to the first payment* to the bank, and October 19, 1935, was *subsequent to the last payment.* [Tr. pp. 39-42.] There is not a word of testimony that Klipstein knew anything about the condition of the company during this period or that he even knew that the payments were being made from the company's funds. Indeed, from his belief in the identity of Stelzner and the company it is obvious that, had he known the source of the payments, in all probability he would have considered them perfectly proper. [Tr. p. 61.]

Under these circumstances no finding of actual fraud could have been made or contemplated in connection with the payments to the bank.

The same is true as to the findings relating to the suit and execution sale, already shown to be irrelevant to Sears' cause of action by reason of the fact that the corporation was in no way injured thereby. Klipstein's motives in this regard are clear and uncontradicted. He discovered the condition of Stelzner's business a few months prior to October, 1935. [Tr. p. 60.] He believed himself a creditor of the company as well as of Stelzner and he admitted that his actions were motivated by a desire to protect himself, as well as Stelzner and the other creditors. [Tr. p. 61.] If there had been the slightest desire on his part to obtain any secret advantage or *delay* creditors it is hardly conceivable that he would have caused a public sale, procured cash bidders, and have *notified* creditors of the proceedings through the local representative of the Los Angeles and San Francisco Boards of Trade who now prosecutes this action on behalf of the creditors, nor would he in addition have offered to yield the claim to which he considered himself entitled, for their benefit. [Tr. pp. 61, 63, 64-65.]

Klipstein was obviously ill-advised but his motives were entirely disclosed in his testimony and entirely consistent with the course of action which he pursued. As stated by the Supreme Court of California in *Levy v. Scott,* 115 Cal. 39, 46 Pac. 892 (1896):

> ". . . while there are circumstances in and of themselves unusual, or perhaps in their nature suspicious—circumstances upon which respondent builds a somewhat plausible 'theory' of collusion and fraud —these circumstances comport equally with the theory of honesty and fair-dealing. . . ."
>
> "It is quite true that evidences of fraud are not left lying patent in the sunlight; that fraud itself is

always concealed, and that the truth is to be discovered more often from circumstances, from the interests of the parties, from the irregularities of the transaction, coupled with injury worked to an innocent party, than from direct and primary evidence of the fraudulent contrivance itself. Nevertheless, the evidence of these matters, facts, and circumstances, taken together, must amount to proof of fraud, and not to a mere suspicion thereof, for the presumption of the law, except where confidential relations are involved, is always in favor of the fair-dealing of the parties."

There is one exception to the rule that actual fraud is essential in fraudulent transfer cases in California. This exception arises from the conclusive presumption created by section 3442 when there combine the elements of (1) a transfer without consideration (2) while the transferor is insolvent or contemplates insolvency. If these two elements are present the transfer is void as to existing creditors. Both elements must be pleaded and proved by the creditor.

Emmons v. Barton, 109 Cal. 662, 42 Pac. 303 (1895);

Bank of Willows v. Small, 144 Cal. 709, 78 Pac. 263 (1904);

Parkinson Brothers Company v. Figel, 24 Cal. App. 701, 142 Pac. 135 (1914);

Careaga v. Moore, 70 Cal. App. 614, 234 Pac. 121 (1925);

Foster v. Foster, 123 Cal. App. 1, 10 Pac. (2d) 796 (1932);

Fross v. Wotton, 3 Cal. (2d) 384, 44 Pac. (2d) 350 (1935).

There was admittedly no consideration flowing to the corporation from the payments to the bank. [Tr. p. 56.] Proof of such lack of consideration is alone insufficient, however, and such proof does not cause the burden to shift to the defendants to prove solvency. In *Bank of Willows v. Small,* 144 Cal. 709, 78 Pac. 263 (1904), an action to cancel a deed alleged to have been delivered in fraud of creditors the court commented upon this question as follows:

> "It was necessary for plaintiff to show that it could not collect its claim from the estate of Julian, nor from other property of Nancy Small, before it could complain as to the deed. The deed would not have injured plaintiff if it could still collect the amount of its claim from other sources."

See, also:

> *Fross v. Wotton,* 3 Cal. (2d) 384, 44 Pac. (2d) 350 (1935).

Here there is an entire lack of any proof of insolvency at any time prior to the actual adjudication in bankruptcy. This phase of the evidence has already been considered in the argument addressed to Finding of Fact No. IV and will not be here re-argued.

It is further evident that even if appellee had proved a case of constructive fraud any transfer within the statutory period would only be void as to *existing* creditors. This means as to creditors having claims at the time of the questioned transfer *which claims remain now unpaid.* In so far as any creditor has been paid he is not injured.

Any new advance would make him only a "subsequent creditor" who has no standing to attack the transaction.

Scales v. Holje, 41 Cal. App. 733, 183 Pac. 308 (1919).

See, also:

Globe Bank v. Martin, 236 U. S. 288, 35 S. Ct. 377 (1915).

The failure to prove the existence of such creditors has already been considered in the argument addressed to Finding of Fact IV and will be further considered *infra* with reference to the failure to find the fact that any creditor or creditors remains or remain unpaid.

The decree cannot therefore be sustained under the sections of the Civil Code above considered. Reiterating appellant's contentions briefly, there is no evidence of a "transfer," or of "actual fraud," or of insolvency necessary to create constructive fraud, or of existing creditors still unpaid whose claims total the amount of the decree. These failures of proof entail an entire failure to sustain a decree based upon the California law considered.

The evidence does not support the decree under the California law relating to the liabilities of directors and officers of corporations for the reasons that (a) the undisputed evidence shows that Klipstein was never a de jure officer or director of the drug company and there is no substantial evidence that he was a de facto officer or director, and (b) there is no evidence that there were creditors existing at the time of the alleged transfers whose claims equal the amount of the decree and are still unpaid.

The theory of Sears' second count is that Stelzner and Klipstein were guilty of violation of the law relating to liabilities to creditors of directors and officers of corporations. [Tr. p. 9.] The statutory provisions in this regard are contained in section 363 of the Civil Code, replacing former section 309. Inasmuch as section 363 and its predecessor have been subject to frequent amendment it is of exceeding importance to note the changes in the statutory provisions over the period of the existence of these sections in order properly to interpret the judicial decisions construing them.

Former section 309 was enacted as part of the Civil Code of California on March 21, 1872, and was based on Stats. 1850, p. 348; Stats. 1861, p. 607, section 50; Stats. 1865-66, p. 747, section 12; Stats. 1865-66, p. 757, section 13; Stats. 1861, p. 626, section 56; and Stats. 1853, p. 89, sections 13 and 14. Minor amendments were made in 1891 (Stats. and Amdts. 1891, p. 468) and 1905 (Stats. and Amdts. 1905, p. 558). As amended to and including 1905 (omitting immaterial portions) section 309 read as follows:

> "The directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they create any debts beyond their subscribed capital stock; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock, except as hereinafter provided, nor reduce or increase the capital stock, except as herein specially provided. For a violation of the provisions of this section, the directors under whose administration the same may have happened (except those who may have caused their dissent therefrom to be entered at large on the minutes

of the directors at the time, or were not present when the same did happen) are, in their individual or private capacity, jointly and severally liable to the corporation, and to the creditors thereof, to the full amount of the capital stock so divided, withdrawn, paid out, or reduced, or debt contracted;"

Thereafter no amendments were passed until 1917, when certain provisions of the section were eliminated by Stats. and Amdts. 1917, p. 657. As so amended and in effect at the date of the incorporation of Globe Drug Company, Inc., section 309 read as follows (omitting immaterial portions):

"Unless they shall have been first permitted or authorized so to do by the commissioner of corporations, directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they create any debts beyond their subscribed capital stock; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock, except as hereinafter provided, nor reduce or increase the capital stock, except as provided in section three hundred fifty-nine of this code. For a violation of the provisions of this section, the directors under whose administration the same may have happened (except those who may have caused their dissent therefrom to be entered at large on the minutes of the directors at the time, or were not present when the same did happen) are, in their individual or private capacity, jointly and severally liable to the corporation, and to the creditors thereof, to the full amount of the capital stock so divided, withdrawn, paid out, or reduced or debt contracted."

Section 309 remained in the above form until 1929 when a radical change in its provisions was affected by Stats. and Amdts. 1929, p. 1266, by which the section was amended to read as follows (omitting immaterial portions):

"Unless they shall have been first permitted or authorized so to do by the commissioner of corporations, directors of corporations must not make dividends except from the surplus profits arising from the business thereof; nor must they divide, withdraw, or pay to the stockholders, or any of them, any part of the capital stock, except as hereinafter provided; provided that dividends may be paid upon shares entitled to cumulative preferential dividends from paid-in surplus, as well as from profits arising from the business, but the holders of such shares shall be notified when dividends are paid from paid-in surplus. Nothing herein prohibits a division and distribution of the capital stock of any corporation which remains after the payment of all its debts, upon its dissolution or the expiration of its term of existence.

In case of any wilful or negligent violation of the provisions of this section, the directors under whose administration the same shall have happened, except those who cause their dissent therefrom to be entered on the minutes of such directors at the time, or were not present at that time, shall be jointly and severally liable to the shareholders of such corporation to the full amount of any loss sustained by such shareholders, or in case of the insolvency of the corporation to the corporation or its receiver, liquidator or trustee in bankruptcy to the full amount in either case of any loss sustained by the shareholders or creditors by reason of such unauthorized dividend, withdrawal or distribution."

In the general revision of the corporation law of California in 1931 the material covered by section 309 was amended and re-numbered 363 by Stats. 1931, p. 1850, which section as amended went into effect on August 14, 1931. This new section (omitting immaterial portions) reads as follows:

> "Except as provided in this title, the directors of a corporation shall not authorize or ratify the purchase by it of its shares with corporate funds nor declare or pay dividends nor authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.
>
> In case of any wilful or negligent violation of the provisions of this section, the directors under whose administration the same shall have happened, except those who may have caused their dissent therefrom to be entered on the minutes of the meeting at which such action was authorized, or who were not present at the time, shall be jointly and severally liable to the corporation and to shareholders and subscribers for the full amount of any loss sustained by the corporation, the shareholders and/or subscribers.
>
> In case of the insolvency of the corporation the directors shall be jointly and severally liable to the corporation or its receiver, liquidator or trustee in bankruptcy to the full amount of any loss sustained by the shareholders or creditors by reason of such unauthorized dividend, withdrawal or distribution.
>
> A director shall not be held to have been negligent within the meaning of this section if he relied and acted in good faith upon a balance sheet or profit and loss statement of the corporation represented to him to be correct by the president or the officer of the corporation having charge of or supervision of its ac-

counts, or certified to be correct and according to the books of the corporation by a public accountant or firm of public accountants selected with reasonable care."

The latest amendment to section 363 was passed in 1933 (Stats. and Amdts. 1933, p. 1396) and the section as thus amended went into effect on August 21, 1933, and has not been further modified since that time. The present section (omitting immaterial portions) reads as follows:

"Except as provided in this title, the directors of a corporation shall not authorize or ratify the purchase by it of its shares or declare or pay dividends or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.

In case of any wilful or negligent violation of the provisions of this section the directors under whose administration the same shall have happened, except those who may have caused their dissent therefrom to be entered on the minutes of the meeting at which such action was authorized, or who were not present at the time the board acted, shall be jointly and severally liable to the corporation or to its receiver, liquidator or trustee in bankruptcy for the benefit of the creditors of the corporation or any of them and of the shareholders and owners of shares at the time of such violation, for its debts and liabilities existing at the time of such violation, and for the full amount of any loss sustained by such holders and owners of shares other than shares upon which any such payment or distribution was made, in any such case not exceeding the amount of such unlawful dividends, purchase price, withdrawal or other distribution.

Any judgment creditor of the corporation, or two or more such creditors, if the debt or claim arose prior

to the time of such violation, may sue the corporation and any or all of its directors in one action and recover judgment for the amount due such creditors or claimants from the corporation against any or all of such directors guilty of any such violation up to the amount of such unlawful dividends, purchase price, withdrawal or other distribution. An action against such directors for any such violation may be brought by the corporation or by its receiver, liquidator or trustee in bankruptcy for the benefit of all of such creditors, owners of shares and shareholders without the necessity of any prior judgment against the corporation, for the recovery of the amount of such dividends, purchase price, withdrawal or other distribution as far as needed to satisfy such debts and liabilities and the full amount of loss sustained by such shareholders.

A director shall not be held to have been negligent within the meaning of this section if he relied and acted in good faith upon a balance sheet or profit and loss statement of the corporation furnished or exhibited to him by the president or the officer of the corporation having charge of or supervision of its accounts, or certified to be correct and according to the books of the corporation by a public accountant or firm of public accountants selected with reasonable care."

The trend in statutory provision is clear from these sections. Section 309 established an absolute liability. Certain acts were prohibited and in the event of the occurrence of any prohibited act liability was automatically imposed upon the designated persons. Whether or not anyone, creditor or stockholder, had been injured was immaterial.

Talcott Land Company v. Hershiser, 184 Cal. 748, 195 Pac. 653 (1921). Good faith on the part of a director was of no significance. *Southern California Home Builders v. Young,* 45 Cal. App. 679, 188 Pac. 586 (1920).

The period of existence of section 309 in its more severe form corresponds roughly with the period during which stockholders in California were subject to liability for corporate debts under section 3 of Article XII of the California Constitution of 1879, and former section 322 of the Civil Code. California corporations were made true limited liability companies by the elimination of this constitutional provision in 1930. Thereafter, in 1931, followed a general revision of the corporation laws, bringing them more in harmony with modern provisions and practice in other states.

The change with reference to the liability of directors is explained by Professor Henry Winthrop Ballantine, who served as draftsman of the Committee of the State Bar on Revision of the California Laws for the 1929 and 1931 sessions of the legislature, in his treatise on California Corporation Laws (1932), as follows:

> "Under the former law the liability of directors for unauthorized dividends did not depend upon their wilfulness or negligence and the fact that no one was injured by an unauthorized dividend did not excuse the directors. The corporation could sue without reference to any damage to creditors or shareholders. This rule was changed by the amendment of 1929. Under section 309 as amended, as under the present law, the right to recover against directors depends upon culpability and whether creditors or shareholders have been injured."

In considering the substantiality of the evidence to support the decree on the basis of section 363 the first point to be noticed is that Klipstein was at no time a *de jure* director or officer of the drug company. No permit to issue its shares was ever issued to the company by the Corporation Commissioner of the State of California. [Tr. pp. 57, 64.] Under the California Corporate Securities Act prior to 1931 shares issued without a permit or contrary to the terms of any permit were absolutely void. See:

Ballantine, opus cit., p. 606;

General Laws of California (Deering, 1923), Act 3814, section 12;

Klinker v. Guarantee Title Co., 98 Cal. App. 469, 277 Pac. 177 (1929);

Castle v. Acme Ice Cream Company, 101 Cal. App. 94, 281 Pac. 396 (1929).

The shares placed in Klipstein's name as security did not therefore make him a *de jure* stockholder. He would not have been liable to the creditors of the corporation on any stockholder's liability. *Regan v. Albin,* 219 Cal. 357, 26 Pac. (2d) 475 (1933). At this time only stockholders could be *de jure* directors. See former section 305 of the Civil Code (Stats. and Amdts. 1905, p. 503); *Rozecrans Gold Mining Co. v. Morey,* 111 Cal. 114, 43 Pac. 585 (1896). A subsequent change in the law did not operate to make him such. *Rozecrans Gold Mining Co. v. Morey, supra.* In addition he would not be a *de jure* director in any event after the ending of the term for which he was elected. *Kinard v. Ward,* 21 Cal. App. 92, 130 Pac. 1194 (1913).

Any liability on Klipstein's part must therefore be predicated on the theory that he was a *de facto* director and officer. Before considering the substantiality of the evidence in this connection it is appropriate to discuss briefly the principles underlying the idea of *de facto* directors and officers.

The law relative to *de facto* officers arises from the same considerations which govern the law in its dealing with apparent agents in the field of contracts, or of promissory estoppel in the field of offer and acceptance, or of equitable estoppel in the general field of the law. The underlying idea is that a person who assumes to act where he has no right will be held responsible as if he had that right and that other persons who allow him to assume any such position will not be heard to say that the assumption was not rightful. In the case of officers and directors of corporations the most common instance of the use of the principles of *de facto* directorship is where the corporation is trying to evade an obligation entered into on its behalf by persons who may not have been authorized so to act with all due formalities. It would of course be grossly inequitable to allow such an avoidance of an obligation, especially if the stockholders have acquiesced in the actions of the purported directors, and the law is settled that in such a case the corporation will be bound. See 6 *Cal. Jur.*, p. 1046, section 423, and cases therein cited.

This is in reality no more than the law of apparent or ostensible agency. See *American Concrete Units Co., Inc., v. National Stone Tile Corp.*, 115 Cal. App. 501, 1 Pac. (2d) 1084 (1931); Morawetz, Private Corporations (2d Ed.), Vol. 2, section 640. Likewise, a person assuming to act as a director is held to the same duties

to shareholders as a legally elected director and cannot evade his obligations by pointing to an imperfection in his title to office. *People v. Leonard,* 106 Cal. 302, 39 Pac. 617 (1895). This is simply a part of the law of estoppel.

The character of the acts which a person must perform in order to be tagged with the designation "*de facto* director" varies with the type of relief sought. This is not explicit in the decided cases but can be seen clearly below the surface. *Eel River Navigation Co. v. Struver,* 41 Cal. 616 (1871); *First African M. E. Zion Church v. Hillery,* 51 Cal. 155 (1875); *People v. Leonard,* 106 Cal. 302, 39 Pac. 617 (1895); *Rozecrans Gold Mining Company v. Morey,* 111 Cal. 114, 43 Pac. 585 (1896); *Barrell v. Lake View Land Co.,* 122 Cal. 129, 54 Pac. 594 (1898); *Sherwood v. Wallin,* 154 Cal. 735, 99 Pac. 101 (1908); *Chandler v. Hart,* 161 Cal. 405, 119 Pac. 516 (1911); *Kinard v. Ward,* 21 Cal. App. 92, 130 Pac. 1194 (1913). Inasmuch as the California decisions are not numerous and contain few discussions of the basis of *de facto* directors' liability the underlying considerations upon which the doctrine is founded must be kept in mind in order to understand the results in particular cases. The definition from Fletcher, Cyclopedia of Corporations (Perm. Ed. 1931), Vol. 2, p. 145, already quoted *supra,* by its very wording illustrates these considerations:

> "One in actual possession of an office under claim and color of election or appointment, and *continually exercising its functions and discharging its duties,* is an officer *de facto.*"

The point most stressed is the "assumption" of corporate office. Turning to the record on this appeal it is evident that there is absolutely no proof of any sort that

Klipstein "assumed" to act for the corporation in any capacity *during the entire period of the withdrawals.* The meetings in December, 1927, and January, 1928, were obviously perfunctory. All such meetings were *prior* to any withdrawals of corporate funds. [Tr. pp. 39-42.] From the time of the last of these meetings until the meeting of October 19, 1935, the drug company was run entirely by Stelzner. Klipstein was in the title business and had no interest in the drug store. There is no evidence that he ever took part in the management of the store in any capacity or that he knew anything at all about its affairs. This was the period when Stelzner withdrew over his own signature all of the funds which were paid to the bank. It was only *subsequent* to all such withdrawals and in an attempt to salvage something for the benefit of all parties that Klipstein again assumed to act as director of the company in forcing Stelzner to execute with him a corporate note for the balance of the debt owed to the bank. [Tr. pp. 60-61.] As shown above, the corporation in so far as creditors are concerned was uninjured by the giving of the note, which it never paid, or by the suit and execution sale which followed. The corporation and its creditors received all the benefits of these actions.

Under these circumstances how can it be said that Klipstein ever assumed to act for the corporation at the times when the various withdrawals of funds were made? There is absolutely no evidence of any action on his part of any nature as a corporate officer during this time. To say that the purported election in 1928 placed upon Klipstein the duty to remain in contact with the affairs of the drug store would be to ignore the fact that Stelzner was

the sole person interested in the business and would make the mechanics of the transaction by which Klipstein aided his brother-in-law a veritable trap in which he would be caught and made to answer for acts with which he had no connection whatsoever. The original incorporators, who were the only *de jure* directors of the company, were as much connected with the corporate affairs as Klipstein, which is to say not at all. To Klipstein Stelzner and the drug store were identical. Klipstein had no interest in the business, knew nothing about it, and paid no attention to it. The transactions involving the withdrawal of funds were entirely between Stelzner and the bank. As long as Stelzner made payments from any source which kept the bank satisfied Klipstein had no cause to investigate or question anything. There is of course no evidence that the drug store was Stelzner's only asset and no showing that Klipstein had any reason to believe that such payments were not being made from Stelzner's personal funds.

It is just and reasonable that anyone assuming to act for a corporation should be held to a strict standard of accountability. It would be most unjust and unreasonable, on the other hand, to ignore the realities of a one-man corporation and to say that any connection, however nominal, would entail a liability in a case where the person sought to be held liable never at any time received any benefit at all and took no active part in any of the transactions.

A further reason why Klipstein cannot be held liable under the provisions of section 363 is that this section specifically excepts from liability any director who was not present at the time when a prohibited withdrawal was authorized by the Board. In this case it is undisputed

that Klipstein never attended any Board meetings during any part of the period over which the withdrawals were made. As a matter of fact Stelzner completely filled the position ordinarily occupied by a board of directors and his affairs and those of the company were so far identical that Klipstein had ample reason, under California law, to consider one the *alter ego* of the other in relation to all the transactions in question. See *Sargent v. Palace Cafe Co.*, 175 Cal. 737, 167 Pac. 146 (1917); *Scales v. Holje*, 41 Cal. App. 733, 183 Pac. 308 (1919). Under these circumstances Klipstein is completely within the exception mentioned and no liability on his part can be predicated upon the provisions of this section.

Even assuming that Klipstein were otherwise liable under section 363 a reading of that section will disclose that the liability created therby is so limited that the evidence in this case could not support a decree for the amount found due by the trial court. By its provisions liability is imposed upon directors only *"for the debts and liabilities existing at the time of such violation."* Paragraph 3 of the section provides that any judgment creditor may sue a director *"if the debt or claim arose prior to the time of such violation"* and further provides that when the action is brought by a trustee in bankruptcy it is considered to be for the benefit of all *such* creditors and recovery is limited to the amount needed to satisfy *such* debts and liabilities.

The extent of the liability created by this section is clear. It is limited to the amount due to any creditor, whether suing on his own behalf or through a trustee in bankruptcy, and *part of the creditor's cause of action is to show that the debt still unpaid arose prior to the time of*

the asserted violation. Appellant has already discussed the failure of proof on this score above in this brief. All that Sears attempted to show at the trial was that at the time of any one particular withdrawal there existed one certain creditor whose claim at the moment upon an open book account exceeded the amount of the withdrawal. For all the proof shows this one creditor might have been paid in full on the next day following each withdrawal. There is no showing that the same obligation remained throughout the entire period and as a matter of fact it is obvious that Stelzner was constantly purchasing from this creditor so that the current balance would have no significance whatsoever. Sears has proved nothing to take McKesson and Langley out of the class of "subsequent creditors" who, by the very words of the statute, cannot complain.

The decision of the trial court in this case was rested by it solely upon the authority of one case, *In re Wright Motor Company,* 299 Fed. 106 (C. C. A. 9, 1924), in which this Court affirmed the decision of the District Court for the Northern District of California in *Oliver v. Brennan,* 292 Fed. 197 (1923). See Minute Order of December 4, 1937 [Tr. p. 24].

The decision in the *Wright Motor Company* case rests upon facts entirely different from those in the case at bar and was based upon provisions of law not in effect when the events in this case took place.

In that case Oliver, trustee in bankruptcy of Wright Motor Company, Ltd., brought suit in equity against one Brennan to set aside certain transfers of money and personal property made by the bankrupt. The evidence showed that the bankrupt was incorporated on February 26, 1920, for the purpose of dealing in automobiles, and

that the incorporators were one West, one Wright, and the defendant Brennan, who was an attorney at law. The capital stock was $37,500, divided into 375 shares of the par value of $100. In March, 1920, 125 shares were issued to Brennan and 125 shares to Wright, for which each paid $12,500 cash, and 125 shares to West for certain physical assets. These three parties continued as sole stockholders, directors and officers until July 14, 1920.

On April 24, 1920, by written contract, Wright agreed to buy Brennan's 125 shares and West's 125 shares (for which Brennan had originally put up the money) and to pay Brennan $25,000 in designated installments. At the time when this contract was executed Wright had no personal funds, a fact which was known to Brennan. Performance of the contract was undertaken and on the day of its execution an initial payment of $10,000 was made. This money was paid directly by the corporation to Brennan by a corporate check signed by Brennan. The corporation received a note from Wright for $10,000, which note seems to have subsequently disappeared. Thereafter and up to August 31, 1920, other corporate checks were delivered to Brennan, for which the corporation received no notes or other consideration. By that day Brennan had received a total of $18,472.92 and in addition substantial personal property from the corporation. By November 13, 1920, all but $500 of the purchase price of the stock had been paid to Brennan, either in cash or in property. On February 26, 1921, exactly a year after its incorporation, the corporation assigned for the benefit of creditors and on May 4, 1921, was adjudicated a bankrupt. On this day it had assets of $868.40 against claims amounting to $9,436.95. The evidence further showed that Bren-

nan, an attorney, was at all times acquainted with the condition of the business and had deliberately attempted to dispose of his shares and recover back his investment in order to avoid liability to creditors of the company.

The difference in the factual situation in the *Wright Motor Company* case and in the case at bar is apparent. There Brennan was a *de jure* director and officer and actively participated in the automobile business. Here Klipstein was never a *de jure* director or officer and never took any part in the management of the drug business. Brennan was the beneficial owner of a large proportion of the legally issued stock and himself participated in the very transaction by which actual cash and personal property, in fact almost the entire assets of the corporation, were transferred directly to him. Klipstein never beneficially owned any stock and even the pledged stock was void, unknown to him. Klipstein took no part at all in any transaction involving any withdrawal of funds from the corporation and never received one cent in cash or any other property of any kind belonging to the drug company. Brennan knew intimately the financial condition of the auto company, knew that under California law stockholders were proportionately liable for its debts and deliberately attempted to rid himself of his stock and escape with his investment. Klipstein knew nothing of the drug company's affairs, knew nothing about creditors until a few months prior to October, 1935, and his actions thereafter were taken in order to preserve rather than dissipate the assets of the corporation. Wright Motor Company, Inc., made an assignment for the benefit of creditors one year to the day after its incorporation and was adjudicated a bankrupt within three months thereafter. Klip-

stein, according to the undisputed evidence, had not the slightest connection with the drug company for a period of over *seven and one-half years* prior to the time when he first heard that there were any unpaid creditors. Such contrasts between the two sets of facts could be continued almost throughout every step of the two cases. In fact it is obvious that the positions of Brennan in the *Wright Motor Company* case and of Klipstein in the case at bar are as different as day and night.

The *Wright Motor Company* case could not have been decided otherwise than it was. In 1920, when the events in that case took place, every stockholder of the corporation was liable for his proportionate part of its debts (California Constitution of 1879, Article XII, section 3; Civil Code, section 322; Kerr's Cyc. Codes, 2d Ed., 1920). This was the liability that Brennan attempted to evade. In 1920, under section 309 of the Civil Code, directors were liable for impairment of the capital stock regardless of good faith or injury to any person. *Southern California Home Builders v. Young,* 45 Cal. App. 679, 188 Pac. 586 (1920); *Talcott Land Company v. Hershiser,* 184 Cal. 748, 195 Pac. 653 (1921). When the events in the case at bar took place these provisions had all been abolished. Klipstein would not have been personally liable for any part of the corporation's debts even had he been the beneficial owner of legally issued stock. The absolute liability provided for in former section 309 of the Civil Code had been eliminated and replaced by section 363 establishing liability of directors only on a basis of bad faith or negligence plus actual injury to stockholders or creditors. At the time of the decision in the *Wright Motor* case the Federal Court was free, under the doctrine of

Swift v. Tyson, 41 U. S. 1, 10 L. Ed. 865 (1842), to consider the decisions of other states or the general law in deciding the case. This is no longer proper since the decision in *Erie Railroad v. Tompkins,* 304 U. S. 64, 58 S. Ct. 817 (1938). Both as to the law and as to the facts the *Wright Motor Company* case is no authority whatever for the imposition of liability upon Klipstein in the case at bar.

A corporation is only a form of business organization and the fictions built up around the idea of corporate entity have never blinded the courts to the realities lying beneath these fictions. While there were three persons actively interested in the Globe Drug Company the corporate device served a useful and practical purpose. Corporate stock distribution determined the property interests of the parties and corporate practice provided a method for the settlement of business policies. After Stelzner bought out the interests of his co-owners the corporate form was entirely disregarded. To all intents and purposes the business was a sole proprietorship with Klipstein holding what might be called an equitable lien on a portion of the assets for moneys advanced to the proprietor. Stelzner alone ran the drug business, determined its policies and knew the condition of its financial affairs.

To hold that the retention of the shell of corporate organization, never legally completed by the issue of valid stock, should give Stelzner the power to impose upon Klipstein personal liability through transactions in which

Klipstein took no part, of which he had no knowledge and from which he derived no benefit, would be to throw a commercial loss upon a party not in the least responsible for its creation. The very creditor whose representative testified at the trial knew more about Stelzner's business than did Klipstein. It saw fit to deal with Stelzner over a period of more than seven years in which it allowed him open credit to the extent of several thousand dollars. It in no way relied upon Klipstein's connection with the enterprise. Now, through the trustee, it desires to recoup its loss from a person whom it probably never knew existed and who took no part in its relations with Stelzner. No such result is legally sustainable or intrinsically just.

The decree is not supported by the findings in that there is no finding that any creditors have proved their claims in the bankruptcy proceedings and remain unpaid.

Assignment of Error No. XXV [Tr. p. 88].

> "The Court erred in making and entering its decree, as amended, for the reason that the facts found do not sustain said decree."

In his amended bill Sears alleged as follows:

> "The above mentioned creditors of said corporation have duly proved their claims in said bankruptcy proceedings; there are not sufficient assets in the bankrupt's estate with which to pay such claims in full, and unless said payments made by said corporation,

and said property, or its value, are restored to the bankrupt's estate, the claims of said creditors will remain unsatisfied." [Paragraph VIII, Tr. p. 8.]

These allegations were specifically denied by Klipstein in his answer. [Paragraph VIII, Tr. p. 12.]

No proof was introduced that any creditor's claim had been proved or approved in the bankruptcy proceedings or that any creditor remained unpaid at the time of the commencement of this suit, and the trial court made no attempt to find on these issues. *This failure to make a finding is fatal to Scars' case on appeal.* Equity rule No. 70½ provides that the trial court must find specially upon the issues raised. The sufficiency of the findings to support the decree in this case is before this court and obviously, no matter what Stelzner or Klipstein might have done in any event, there is no legal damage shown and therefore no liability unless creditors prove some injury existing at the time of the commencement of the suit.

Appellant has already shown that under both the "constructive fraud" theory and under section 363 of the Civil Code part of the creditor's case is the proof of a claim (1) in existence at the time of the transaction attacked, and (2) unpaid at the commencement of the action, and no further citation of authorities is necessary on this point. The absence of a finding that there was any such creditor so injured and that there were insufficient assets within which to pay approved claims makes the affirmance by this court of any decree in any amount impossible.

The decree entered is void in that the extent of Klipstein's liability is made thereby to depend upon a report made by a referee in a proceeding in which Klipstein is not represented and has no standing to dispute the propriety of any items in such report.

Assignment of Error No. XXVII [Tr. p. 88].

> "The Court erred in making and entering its decree, as amended, for the reason that said decree is void in that the liability of defendant to plaintiff is made by said decree to depend upon a report to be filed by one C. E. Arnold, Referee in Bankruptcy in the matter of the estate of the Globe Drug Company, Inc., bankrupt, in which proceeding in bankruptcy defendant is not represented and has no standing and defendant is therefore by said decree deprived of his day in court to litigate the reasonableness and propriety of any allowance and expenses included in said report to be filed by said Referee."

The trial court in its decree [Tr. p. 32] provided that Klipstein's liability should be determined by a report to be filed in the action by the referee in bankruptcy appointed in the bankruptcy proceedings of the corporation, and further directed that Sears have execution against Klipstein for the amount shown in such report.

In making and entering any such decree the trial court obviously exceeded its jurisdiction. Federal District Courts have the power to appoint referees in appropriate cases but the opportunity of each party to be heard in the proceedings before such referee is indispensable (see former Equity Rule 60; Federal Rules of Civil Procedure, Rule 53), and no report rendered by any such referee is

of any effect until approved by the court. *North Carolina R. R. Co. v. Swasey*, 90 U. S. 405, 23 L. Ed. 136 (1875). Klipstein is not represented, personally or otherwise, in the bankruptcy proceedings and would have no standing to contest the propriety of any claims or any expense allowances. As was said in *Postal Telegraph-Cable Co. v. Newport*, 247 U. S. 464, 38 S. Ct. 566 (1918): "The opportunity to be heard is an essential requisite of due process of law in judicial proceedings." The fact that the decree summarily deprives Klipstein of his day in court to litigate the extent of his liability renders the decree void on its face irrespective of all other considerations.

Conclusion.

Ths legislature of California has enacted as an important and integral part of the new California law section 363 of the Civil Code.

The opinion on this appeal will constitute the first interpretation of any court as to the meaning, validity and effect of certain amendments to that section.

Incidental to such interpretation this Honorable Court will also determine whether and how such amendments apply to this case.

It is presumed that the legislature knew the prior state of the law, as it stood at the time of the decision in the case of *In re Wright Motor Co., supra, and sought by the amendments to make some change therein.* Other things being equal, it will also be presumed that the legislature used the words of such amendments in their *plain, ordinary meaning.*

The legislative intent being plain, there is no need or room for consideration of policy, and it becomes the duty of the courts to give to such legislative enactments the meaning intended by the legislature.

A rule of a branch of the substantive law of the State of California, has expressly placed upon the appellee the duty of establishing the several elements of the case necessary to support a decree. Appellee must have recognized this necessity or he would not have attempted to plead these elements in his bill of complaint.

No evidence being given "his case fails."

As we have pointed out there is no evidence of (a) fraudulent intent on the part of Klipstein, or actual fraud of any kind on his part, (b) insolvency of the drug company at any time prior to its adjudication in bankruptcy, (c) that the claims of creditors, or any creditor, was equal to the amount of the decree, or, (d) that any creditor remained unpaid or does now remain unpaid.

Without again enumerating them, it clearly appears that appellee has also failed to give any evidence, or sustain the burden of proof, or comply with the Civil Code provisions, on other equally important propositions of law, each essential to a valid decree.

Appellant, therefore, respectfully requests that the decree as entered by the trial court herein be reversed.

Respectfully submitted,

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